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And Now the Great Depression

Barry Eichengreen | Sep 23, 2008

A couple of months ago at lunch with a respected Fed watcher, I asked, "What are the odds are that U.S. unemployment will reach 10 per cent before the crisis is over?" "Zero," he responded, in an admirable display of confidence. Watchers tending to internalize the outlook of the watched, I took this as reflecting opinion within the U.S. central bank. We may have been in the throes of the most serious credit crisis since the Great Depression, but nothing resembling the Depression itself, when U.S. unemployment topped out at 25 per cent, was even remotely possible. The Fed and Treasury were on the case. U.S. economic fundamentals were strong. Comparisons with the 1930s were overdrawn.

The events of the last week have shattered such complacency. The 3 month treasury yield has fallen to "virtual zero" for the first time since the flight to safety following the outbreak of World War II. The Ted Spread, the difference between borrowing for 3 months on the interbank market and holding three month treasuries, ballooned at one point to five full percentage points. Interbank lending is dead in its tracks. The entire U.S. investment banking industry has been vaporized.

And we are in for more turbulence. The Paulson Plan, whatever its final form, will not bring this upheaval to an early end. The consequences are clearly spreading from Wall Street to Main Street. The recent performance of nonfinancial stocks indicates that investors are well aware of the fact.

So comparisons with the Great Depression, which have been of academic interest but little practical relevance, take on new salience. Which ones have content, and which are mainly useful for headline writers?

First, the Fed now, like the Fed in the 1930s, is very much groping in the dark. Every financial crisis is different, and this one is no exception. It is hard to avoid concluding that the Fed erred disastrously when deciding that Lehman Bros. could safely be allowed to fail. It did not adequately understand the repercussions for other institutions of allowing a primary dealer to go under. It failed to fully appreciate the implications for AIG's credit default swaps. It failed to understand that its own actions were bringing us to the brink of financial Armageddon.

If there is a defense, it has been offered Rick Mishkin, the former Fed governor, who has asserted that the current shock to the financial system is even more complex than that of the Great Depression. There is something to his point. In the 1930s the shock to the financial system came from the fall in the general price level by a third and the consequent collapse of economic activity. The solution was correspondingly straightforward. Stabilize the price level, as FDR did by pumping up the money supply, and it was possible to stabilize the economy, in turn righting the banking system.

Absorbing the shock is more difficult this time because it is internal to the financial system. Central to the problem are excessive leverage, opacity, and risk taking in the financial sector itself. There has been a housing-market collapse, but in contrast to the 1930s there has been no general collapse of prices and economic activity. Corporate defaults have remained relatively low, which has been a much-needed source of comfort to the financial system. But this also makes resolving the problem more difficult. Since there has been no collapse of prices and economic activity, we are not now going to be able to grow or inflate our way out of the crisis, as we did after 1933.

In addition, the progress of securitization complicates the process of unraveling the current mess. In the 1930s the Federal Home Owners Loan Corporation bought individual mortgages to cleanse bank balance sheets and provide home owners with relief. This time the federal agency responsible for cleaning up the financial system will have to buy residential mortgage backed securities, collateralized debt obligations, and all manner of sliced, diced and repackaged paper. Strengthening bank balance sheets and providing homeowners with relief will be infinitely more complex. Achieving the transparency needed to restore confidence in the system will be immensely more difficult.

That said, we are not going to see 25 per cent unemployment rates like those of the Great Depression. Then it took breathtaking negligence by the Fed, the Congress and the Hoover Administration to achieve them. This time the Fed will provide however much liquidity the economy needs. There will be no tax increases designed to balance the budget in the teeth of a downturn, like Hoover's in 1930. Where last time it took the Congress three years to grasp the need to recapitalize the banking system and provide mortgage relief, this time it will take only perhaps half as long. Ben Bernanke, Hank Paulson and Barney Frank are all aware of that earlier history and anxious to avoid repeating it.

And what the contraction of the financial services industry taketh, the expansion of exports can give back, what with the continuing growth of the BRICs, no analog for which existed in the 1930s. The ongoing decline of the dollar will be the mechanism bringing about this reallocation of resources. But the U.S. economy, notwithstanding the admirable flexibility of its labor markets, is not going to be able to move unemployed investment bankers onto industrial assembly lines overnight. I suspect that I am now less likely to be regarded as a lunatic when I ask whether unemployment could reach 10 per cent.

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